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TAGS: [ECON](#) [EFIN](#) [EINV](#) [UK](#)  
SUBJECT: PRE-BUDGET REPORT INCREASES SPENDING, RAISES VAT  
AND NATIONAL INSURANCE TAXES, DELAYS CUTS

REF: LONDON 02783

LONDON 00002785 001.2 OF 003

¶1. (U) Summary. UK spending levels for 2010-11 will increase slightly, by GBP 31 billion, up 2.2 percent from current levels, as outlined in the HM Treasury's December 9 Pre-Budget Report (PBR). In his speech on the PBR to Parliament, Chancellor Darling forecast a 4.75 percent contraction for the UK economy, over a percentage point worse than predicted in April, but he was optimistic the UK economy would recover in 2010 and 2011. While outlining medium-term plans to cut the deficit in half, Darling delayed a detailed government spending review until after the 2010 general elections. Opposition parties criticized Darling for not specifically addressing the UK's ballooning debt in the PBR, and called the report "not credible" and a "piece of pre-electioneering." A controversial tax on bonus pay (reftel London 02783) received considerable media coverage, but it will not have a strong impact on government revenues. Other revenue-generating tax measures included an increase in the VAT and a hike in national insurance payments. Darling also announced an increase in defense spending for Afghanistan.

#### Economic Outlook Downgraded, But Still Optimistic

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¶2. (U) Chancellor Darling projected UK GDP would contract 4.75 percent in 2009, over one percentage point worse than an estimate of 3.5 percent he gave in April's Budget Report. However, in a step critiqued by some economists, Darling maintained his April prediction that the economy will grow between 1 and 1.5 percent in 2010 and accelerate to a 3.75 percent pace in 2011. IMF and OECD projected a much more modest 2 to 2.5 percent growth rate in 2011, while the Bank of England expected a much more optimistic 4.1 percent rate. Peter Spencer, chief economist to the Ernst & Young ITEM Club, said medium-term forecasts had been stretched to achieve the Chancellor's objective of halving the deficit in four years. Price Waterhouse Coopers agreed with the Chancellor's 2010 forecast, but projected a much slower recovery beyond that. Darling expected inflation would spike from 1.5 percent to 3 percent early next year and return to 1.5 percent by the end of 2010.

#### Debt Reduction Plans Don't Convince Markets

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¶3. (U) In conjunction with the PBR, Darling introduced to Parliament draft legislation and a plan to control the UK deficit and net public sector debt. He said the government deficit would hit a high of GBP 178 billion this year (12.6 percent of GDP), but the proposed legislation would require the deficit as a share of GDP to fall every year from 2010-2011 to 2015-16. HMT forecast the following deficit to GDP figures: 12 percent in 2010-11, 9.1 percent in 2011-12,

7.1 percent in 2012-13, 5.5 percent in 2013-14, and 4.4 percent in 2013-14. Darling expected net debt to GDP to weigh in at 56 percent this year and climb steadily to a peak of 78 percent of GDP in 2014-15 before starting to fall. He maintained, however, that the UK's debt would be well in line with figures in other G-7 countries, including France, Germany and the U.S. The Chancellor also stated fiscal tightening too soon would delay the recovery and bring on a longer recession, which is in line with G-20 commitments.

¶4. (U) Analysts at the Institute for Fiscal Studies (IFS) questioned, however, the debt forecast, which they said did not include known factors, such as the extra costs of the UK's aging population. While HMT forecasts the UK debt to drop to 40 percent of GDP by 2032, IFS projected a higher debt to GDP ratio of 60 percent for a generation unless additional measures were taken. IFS said HMT's proposed legislation to decrease the debt every year was not sensible because its rules could be broken. IFS also said the overall PBR had slackened the pace of fiscal tightening in the short term, requiring greater tightening in later years. Moreover, IFS economists believed future tightening would have to include more tax increases or spending cuts.

#### Opposition Reaction

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¶5. (U) Shadow Chancellor Osborne said the Government was not being honest with the British people by deferring spending cuts. He stated that the spending review was a missing element of the PBR, and that the government was being "dishonest" about the deficit. It was more of a pre-election report than a Pre-Budget Report, he argued. The Liberal Democrats also criticized the PBR, saying the chancellor had "ducked the hard choices on spending and cuts."

LONDON 00002785 002.2 OF 003

#### Market Reaction

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¶6. (U) Markets were also unconvinced by the Chancellor's efforts to reduce the UK's debt. The day after the PBR, interest rates on UK gilts compared with German government bonds widened and the yield on 10-year UK government bonds rose by 0.14 percent to 3.8 percent, showing investors had lower confidence in the government's ability to pay back its debt and were demanding a higher return for holding UK bonds. Prior to the PBR, credit rating agency Moody's said the UK could lose its triple A rating for government debt if it did not get public finances under control. After the report, however, Moody's said UK and U.S. triple A ratings were resilient for now, though a quick rise in interest rates could test governments' abilities to finance their debt at affordable rates.

#### Tax Increases Impact Middle Class and Rich

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¶7. (U) A new tax on bank bonus payouts (see reftel) dominated media coverage, but it is expected to have a limited impact, raising revenue of GBP 550 million. Far greater impact will be felt from a further 0.5 percent increase in national insurance rates beginning in 2011, which is expected to raise GBP 3 billion per year. Though no one earning under GBP 20,000 will have to pay the added amount, the tax was heavily criticized by the Conservative Party and the Confederation of British Industries as another tax on employers and workers. The increase was on top of a 0.5 percent increase previously announced that goes into effect in next year.

¶8. (U) The VAT will return to 17.5 percent on January 1, following a one-year reduction to 15 percent as part of the Government's fiscal stimulus program. The VAT should raise an additional GBP 7 billion next year, according to HMT data.

Newspapers reported HM Treasury favored a further increase in the VAT to 20 percent instead of national insurance rate increases; such an increase would in HMT's view show the government's commitment to control the deficit. The Prime Minister allegedly overruled the increase. Another important announcement was that the stamp duty holiday, under which properties worth up to GBP 175,000 were not subject to taxation, was scrapped in favor of a return to the previous threshold of GBP 125,000. Mortgage industry actors feared this could hurt the recovery of housing sales.

#### Pensions, Pay and Benefits

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¶9. (U) Darling announced basic state pensions would rise by 2.5 percent in 2010 and child and disability benefits by 1.5 percent. Spending on schools would also rise 0.7 percent in 2011-12 and 2012-2013. Darling also announced free school meals for some low-income families. To offset some of the new measures, he said, however, contributions to public sector pensions would be cut by GBP 1 billion per year and public sector pay increases would be capped at one percent for two years beginning in 2011.

#### Other New Measures: Defense, Small Business, and Environment

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¶10. (U) Other measures in the PBR were aimed at defense and development assistance, small business, and low carbon growth. Highlights included:

-- A further GBP 2.5 billion for military operations in Afghanistan, and a reaffirmed commitment that the UK would meet the United Nations target of contributing 0.7 percent of gross national income to official development assistance by ¶2013.

-- No increase in the 2010 tax rate for 850,000 small businesses and a reduction of corporation tax to 10 percent for income generated from patents in the UK.

-- A proposed Capital Growth Fund for small business seeking loans

-- A six-month extension of the mortgage interest scheme to assist those who had lost their jobs to cover mortgage payments.

-- A tax-free credit of GBP 900 for home wind turbine or solar panels and a tax exemption for electric cars from the company car tax for a five year period.

LONDON 00002785 003.2 OF 003

-- An additional GBP 200 million next year for energy efficiency; GBP 160 million of public and private investment into low carbon projects; and a further GBP 90 million in the European Investment Bank's new 2020 fund, which will enable euros 6.5 billion of finance for green infrastructure projects.

#### Increased Short-term Spending Will Require Cuts Later

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¶11. (U) The Chancellor postponed a Comprehensive Spending Review, which will outline detailed program cuts in every government department, until after the general election, expected in early May 2010. He stated spending will grow slightly in real terms next year totaling 2.2 percent or GBP 31 billion, and he said cuts will not begin until the economy recovers in 2011. He further restated a commitment to preserve front-line spending, which includes health, schools, police, and international commitments to overseas development assistance funding through 2013. Cuts in the areas not ring-fenced would begin from April 2011, long after the

general election results. IFS estimated, a total of GBP 36 billion in cuts in government departments were needed, however, to meet the government's deficit to GDP goals in the three-year period between 2011-12 and 2013-14 of which GBP 15 billion have yet to be announced. IFS calculated that to achieve the deficit reduction targets, public spending would have to shrink by as much as 16 percent over three years in unprotected areas such as defense, higher education, housing and transportation.

¶12. (SBU) Comment: The PBR indicates the Labour government believes it would be too soon to start winding down stimulus measures and begin tackling the debt. Economic recovery in the UK is still very weak, and might not yet be underway at all, as evidenced by the worst-than-expected contraction in GDP. How to manage the deficit will be the dividing line between Labour and the Conservatives in the run-up to the election, but specifics from either party will likely be minimal so as to not risk voter backlash.

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